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The Crane Controversy Continues - Tufts v. Commissioner

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THE *CRANE* CONTROVERSY CONTINUES

Tufts v. Commissioner
651 F.2d 1058 (5th Cir. 1981), *rev'd*, 103 S. Ct. 1826 (1983)

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The Supreme Court holding in *Crane v. Commissioner*[1] is the source of a controversy which remains unresolved despite 35 years of commentary and judicial analysis. *Tufts v. Commissioner*[2] is the latest addition to the extensive body of legal writing aimed at clarifying the rationale and scope of the *Crane* holding. Although *Crane* is the foundation for tax law governing many real property transactions, including many tax shelters,[3] until *Tufts* no court allowed the taxpayer to benefit from the plain language of *Crane*'s footnote 37. *Tufts* is, therefore, an important decision which, if allowed to stand, indicates a dramatic reversal of the conservative interpretations given *Crane*.

In *Crane*, the Court held that the amount of a nonrecourse mortgage securing property is included in the basis of that property and that, upon disposition of the property, the entire remaining balance of the mortgage must be included in the taxpayer's amount realized.[4] The use of nonrecourse financing, a method of financing whereby a loan of money is secured only by a certain piece of property, is advantageous because it reduces the economic risk of investment.[5] *Crane*'s inclusion of a nonrecourse loan in the basis[6] of the property further benefits the

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1. 331 U.S. 1 (1947). *See infra* text accompanying notes 23-44.

2. 651 F.2d 1058 (5th Cir. 1981), *rev'd* 103 S. Ct. 1826 (1983).

3. The *Crane* doctrine has been the foundation of many tax shelters. *See* Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane case*, 33 TAX L. REV. 277, 283 (1978) [hereinafter cited as Bittker]; McGuire, *Negative Capital Accounts and the Failing Tax Shelter*, 3 J. OF REAL EST. TAX 439 (1976) [hereinafter cited as McGuire].

4. 331 U.S. 1 (1947).

5. Nonrecourse loans, once rarely used, are not uncommon today. They are often used in partnerships. A common example of a nonrecourse loan is where the note specifically states that the lender will look only to the property securing the loan and that no mortgagor has any personal liability. Another example is a purchase money mortgage in a state where law provided that no deficiency judgment may be obtained against the buyer on such a mortgage. *See* A. WILLIS, J. DENNELL, P. POSTELWAITE, PARTNERSHIP TAXATION, § 43.04 (3d ed. 1982).

6. I.R.C. § 1012 (1976) provides in pertinent part:

> The basis of property shall be the cost of such property. . . .

Treas. Reg. § 1.1012-1 (1960) provides in pertinent part:

> (a) In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.

taxpayer in two ways. First, losses can be deducted only to the extent of the basis. Including in the basis the amount of nonrecourse liability secured by the property increases the basis of that property and, therefore, increases the total amount of deductions that can be taken.[7] Second, the amount of gain upon the sale or other disposition of the property, which amount is subject to taxation, is the excess of the amount realized over the basis.[8] Thus, a larger basis benefits the taxpayer because it results in a smaller taxable gain.

The *Crane* Court's inclusion of nonrecourse liability in the basis conferred yet another benefit upon subsequent taxpayers. Because depreciation deductions are calculated using the basis which, after *Crane*, included nonrecourse mortgages, the taxpayer was able to take deductions without incurring personal liability. The seeming imbalance of this rule was, however, tempered by its corollary; having benefited from the larger depreciation deductions made possible by the inclusion of the nonrecourse loan amount in the basis, the taxpayer must include the loan amount in the amount realized[9] upon the disposition of the property securing the debt.[10]

The facial equity of this pattern has recently been disturbed. Relying on a footnote in *Crane*, in *Tufts v. Commissioner*,[11] the United States Court of Appeals for the Fifth Circuit recognized an exception to the general rule of inclusion. In *Tufts*, because the fair market value of property secured by a nonrecourse mortgage had declined, upon disposition of the property, the taxpayer received less than the amount of the mortgage. The Fifth Circuit refused to include the entire amount of the nonrecourse mortgage in the amount realized even though the taxpayer had taken depreciation deductions using a basis which included the nonrecourse mortgage. The court held that the portion of a nonrecourse mortgage that must be included in the amount realized upon disposition of the property securing the mortgage is limited to the fair

7. "Deduction" is a general term for an amount that is subtracted from gross income to arrive at taxable income. *See* CHOMMIE, FEDERAL INCOME TAXATION 80 (2d ed. 1973).

8. I.R.C. § 1001 provides in pertinent part:

(a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining the loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

9. I.R.C. § 1001(b) (1976). *See supra* note 8.

10. Crane v. Commissioner, 331 U.S. 1, 5-6 (1947).

11. 651 F.2d 1058 (5th Cir. 1981), *rev'd* 103 S. Ct. 1026 (1983).

market value of the property.[12] The *Tufts* holding is in direct conflict with the earlier Third Circuit holding in *Millar v. Commissioner*.[13] The *Millar* court, under similar facts, included the full amount of a nonrecourse mortgage in the amount realized.

In today's world of highly leveraged real estate tax shelters and mortgaged properties which have declined in value, the importance of a clear understanding of the tax consequences of the disposition of such properties cannot be underestimated. This comment will show that *Tufts* has added to the confusion surrounding this area and will illustrate the necessity for action by the Supreme Court to determine the exact state of the law. This comment will first analyze the Supreme Court's decision in *Crane*. The rationale of *Millar* and *Tufts* will then be examined. Finally, the impact of these decisions will be discussed.

DEFINITIONS

The basis of property is defined as its cost.[14] The basis includes indebtedness, whether recourse[15] or nonrecourse, incurred with respect to the property.[16] Basis is adjusted for depreciation taken.

The amount realized on the sale or other disposition of the property is the sum of "any money received plus the fair market value of any property received."[17] When a taxpayer sells property and is relieved of the liability of a mortgage, the amount of the liability is included in the amount realized.[18] The amount of gain from the sale or other disposition of property equals the excess of the amount realized over the adjusted basis.[19] There is no gain to the extent of the adjusted

12. *Id.* at 1063.

13. Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979).

14. I.R.C. § 1012 (1976). *See supra* note 6.

15. Recourse indebtedness is a personal liability of the debtor. *See* Del Cotto, *Basis and Amount Realized under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. PA. L. REV. 69, 71 (1969) [hereinafter cited as Del Cotto].

16. Crane v. Commissioner, 331 U.S. 1 (1947). *See* Rollyson, *Service Turns the Tables on the Crane Doctrine*, 3 J. OF REAL EST. TAX. 495, 496 (1976).

17. I.R.C. § 1001(b) (1976). *See supra* note 8.

18. Treas. Reg. § 1.1001-2a(4)(1) (1960). *See* Crane v. Commissioner, 331 U.S. 1 (1947); Millar v. Commissioner, 577 F.2d 212, 214-15 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979); Teitelbaum v. Commissioner, 346 F.2d 266, 269 (7th Cir. 1965). *But see* Tufts v. Commissioner, 651 F.2d 1058, 1063 (5th Cir. 1981), *rev'g* 70 T.C. 756 (1978), *rev'd* 103 S. Ct. 1826 (1983) (amount realized did not include the full amount of a nonrecourse mortgage where the amount of the mortgage exceeded the fair market value of the property.)

19. I.R.C. § 1001(a) (1976). *See supra* note 8. For the general method of computing gain or loss through the sale or other disposition of property see I.R.C. § 1001 (a) through (d) (1976). These sections provide that the amount of the adjusted basis prescribed by I.R.C. § 1011 and the regulation thereunder shall be returned to the taxpayer by subtracting such amount from the amount realized. The excess of the amount realized over the adjusted basis constitutes the realized gain. If the amount of the adjusted basis is greater than the amount realized, as loss is

basis[20] because the basis represents the taxpayer's cost of the property and is, therefore, considered a return of capital, not profit.

Despite these well-settled principles, the rules governing the determination of the amount realized are in question when nonrecourse liability is greater than the value of the property. Specifically, the question whether relief from a nonrecourse liability can be viewed as an amount realized to the extent it exceeds the fair market value of the property remains unsettled.[21]

THE RATIONALE OF *CRANE V. COMMISSIONER*

In the landmark case *Crane v. Commissioner*,[22] the Supreme Court for the first time ruled upon the includability in basis and treatment upon disposition of a nonrecourse loan securing depreciable property.[23] The Court held that the basis of property subject to a mortgage includes the amount of the mortgage, whether the mortgage is recourse or nonrecourse, and that when such property is sold the "amount realized" includes the entire remaining balance of that mortgage.[24] The taxpayer in *Crane* inherited an apartment building which was subject to a nonrecourse mortgage of $255,000.[25] During the seven years she

sustained to the extent of the difference between such adjusted basis and the amount realized. *See* Treas. Reg. § 1.1001-1 (1960). Following is an example of the computation of gain:

In Year 1, X purchases an asset for $10,000 paying $1,500 in cash and signing a note for $8,500. X takes depreciation deductions in Year 1 and Year 2 totalling $3,500 and also reduces the amount outstanding on the note to $7,100. X sells the asset in Year 3. The buyer pays $1,200 in cash and assumes liability on the note. X's amount realized is $8,300. ($1,200 + $7,100). Since X's adjusted basis is $6,500 ($10,000 - $3,500), X's gain to the taxpayer is the same whether the note is recourse or nonrecourse.

20. *See* I.R.C. § 1011 (1976).

21. This issue has been the subject of much litigation. *See, e.g.*, Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981), *rev'g* 70 T.C. 756 (1978), *rev'd*, 103 S. Ct. 1826 (1983) (amount realized limited to the fair market value of the property); Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1978) (amount realized not limited by the fair market value of the property); Estate of Delman v. Commissioner, 73 T.C. 15 (1979) (partners realized gain from repossession of equipment was not limited by the fair market value of the equipment); Collins v. Commissioner, 22 T.C.M. (CCH) 1467 (1963) (the amount realized on the cancellation of a nonrecourse note could not exceed the value of the property securing the note). *See also*, Rev. Rul. 76-111, 1976-1 C.B. 214 (where mortgagor transfers property subject to a nonrecourse mortgage to the mortgagee in satisfaction of the mortgage, the amount realized will equal the outstanding balance of the mortgage, even if this amount exceeds the fair market value of the property).

22. 331 U.S. 1 (1947). For a full discussion of *Crane*, see Adams, *Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion*, 21 TAX L. REV. 159 (1966); Bittker, *supra* note 3; McGuire, *supra* note 3.

23. Note, *Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage*, 49 COLUM. L. REV. 845, 846 (1949).

24. *See* Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972) [hereinafter cited as Perry].

25. At the time of decedent's death, Jan. 11, 1932, the apartment building was subject to a mortgage on which there was due $255,000 principal and $7,042.50 accrued interest, a total of

held and operated the property,[26] depreciation deductions were calculated using a basis which included the full amount of the nonrecourse mortgage. When the building was sold, the taxpayer received $3,000 in cash. After deducting $500 in expenses the taxpayer reported a net gain of $2,500 of which $1,250 was taxable gain.[27] The Commissioner, however, determined that the taxpayer realized a gain of $23,767 and assessed a deficiency.[28]

The taxpayer adopted a common-sense position, arguing that because the building was subject to a mortgage, the "property" she inherited was not the physical building itself, but only the equity in the building, or, the excess of the fair market value over the mortgage. Since at the time she inherited the building its value equaled the amount of the mortgage,[29] her equity was zero. The basis of property acquired by devise is the fair market value of such property at the time of acquisition.[30] If the "property" she inherited was only the equity, then her basis was zero. As neither she nor the buyer had ever assumed the mortgage,[31] it could be disregarded. Thus, the taxpayer concluded that her gain on the sale, net cash received less the basis, was $2,500.[32] The Supreme Court rejected the taxpayer's contentions. The Court reasoned that the correct statutory construction of the term "property" is the ordinary, everyday meaning—the land and buildings themselves—not equity, as the taxpayer claimed. Therefore, the taxpayer's basis in the property was its fair market value, $262,042.50.[33]

The Court next addressed the problem of determining the amount

$262,042.50. Crane v. Commissioner, 3 T.C. 585, 586 (1944), *rev'd*, 153 F.2d 504 (2d Cir. 1943), *aff'd* 331 U.S. 1 (1946).

26. On Feb. 1, 1932, and until the property was sold and conveyed on Nov. 29, 1938, the mortgage was in default for nonpayment of interest. In 1932 the taxpayer and the bank holding the mortgage entered into an agreement whereby the taxpayer would operate the apartment building, reserve certain specified amounts for expenses, and remit the excess to the bank to be applied toward the mortgage. The taxpayer never assumed the mortgage. *Id.*

27. 331 U.S. at 3-4. The taxpayer assumed the entire property was a capital asset. According to §§ 117(a), (b) of the Revenue Act of 1938, only 50% of the gain on the sale of a capital asset held for more than 2 years was taxable. Thus, cash received ($3,000) less expenses ($500) equals net gain ($2,500). Net gain ($2,500) x 50% = taxable gain ($1,250). *Id.* at 4, n.3.

28. 331 U.S. at 4. The Tax Court held that the only amount realized by the taxpayer was $2,500 and expunged the deficiency. 3 T.C. 591. The Court of Appeals for the Second Circuit reversed, holding that the amount realized by the taxpayer included the full value of the building. 153 F.2d 504 (2d Cir. 1945). The Supreme Court granted certiorari. 328 U.S. 826 (1945).

29. On Jan. 11, 1932, the property was appraised for federal estate tax purposes at a value of $262,042.50, and the amount due on the mortgage was determined to be the same amount. 3 T.C. at 586.

30. I.R.C. § 1014 (1976) provides that the basis of property acquired from a decedent is the fair market value of the property as of the date of decedent's death.

31. 3 T.C. at 587.

32. *See supra* note 27.

33. 331 U.S. at 11.

realized by the taxpayer upon the disposition of the property. The Court used two theories to justify inclusion of the full amount of the taxpayer's nonrecourse mortgage in the amount realized: the economic benefit theory and the tax benefit theory.[34]

The Economic Benefit Theory

The economic benefit theory is based on the presumption that forgiveness of a recourse debt, a personal liability, results in an economic benefit to the debtor.[35] There is no requirement that money or property be received in order to realize an economic benefit.[36] The *Crane* Court explained that a purchaser who either pays or assumes a seller's mortgage as part of the transaction confers upon the seller a benefit as real and substantial as if money had been paid to the seller and then paid over to the creditor[37] because when the purchaser pays or assumes a mortgage for which the seller is personally liable, the seller is relieved of his obligation to pay. The economic benefit is measured by the amount of the liability forgiven and this amount is then included in the amount realized upon disposition of the property.

The *Crane* Court extended this principle to include a seller who is not personally liable on the mortgage encumbering his property. At first consideration it would appear that such a seller would reap no benefit from having the buyer either assume his nonrecourse mortgage or pay it because he is not personally liable on the debt. There is no benefit in relief from a debt he does not "owe." The *Crane* Court, however, compared the owner whose mortgage is a personal liability to the nonrecourse mortgagor whose property is mortgaged at an amount equal to or less than the fair market value and found that each must treat the conditions of their mortgage the same way in order to retain their property; each must pay the mortgage or forfeit the property. Therefore, the Court reasoned that each must accrue the same benefit upon relief from the debt.[38] The Court concluded that, like the mortgagor whose debt is a personal liability, upon disposition of the property securing the mortgage the nonrecourse mortgagor receives an

34. For a full discussion of these two theories see generally Note, *Millar: Requiem for Crane's Footnote 37*, 41 U. PITT. L. REV. 343 (1980) [hereinafter cited as *Requiem*].

35. *Requiem, supra* note 34, at 348.

36. United States v. Hendler, 303 U.S. 564, 566 (1938); Haass v. Commissioner, 37 B.T.A. 948, 955 (1938); Brons Hotels, Inc. v. Commissioner, 34 B.T.A. 376, 390 (1936).

37. 331 U.S. at 13. *See* Lutz v. Schramm Co., 1 T.C. 682 (1943).

38. 331 U.S. at 14. *See* Del Cotto, *supra* note 15 at 75. *See also* Mayerson v. Commissioner, 47 T.C. 340, 351-52 (1966) (Tax Court untroubled by lack of personal liability).

economic benefit in the amount of the mortgage and such amount must be included in the amount realized from the transaction.

The taxpayer in *Crane* owned property subject to a nonrecourse mortgage. Had she chosen not to pay the mortgage she would have lost the property. In that the result of nonpayment would have been the same if she were personally liable on the mortgage, the Court treated the assumption of the mortgage by the buyer as if the taxpayer was being released from liability on the mortgage. The Court found that upon disposition of the property and assumption of the mortgage by the buyer the taxpayer received an economic benefit equal to the entire amount of the mortgage plus cash received, even though she was never personally liable on that mortgage.

The Court did, however, acknowledge that such might not always be the result. In Chief Justice Vinson's now famous[39] "footnote 37," he stated:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.[40]

The Court suggested that upon disposition of property subject to a nonrecourse mortgage an economic benefit accrues to the seller only insofar as the sales price exceeds the mortgage amount. If the market price of mortgaged property drops below the amount of the mortgage, the mortgagor who is personally liable on the mortgage bears the full loss because the entire amount of the mortgage is still collectible. If the mortgage is nonrecourse, however, the most the mortgagor can lose is the fair market value of the property because taking over the property is the only way such a debt can be satisfied, if it is in default. Therefore, since the loss would be limited, the Court, in its footnote, suggested a limit to the economic benefit that could be realized upon forgiveness of a nonrecourse debt. That limit is the fair market value of the property.

The Tax Benefit Theory

The *Crane* Court also relied upon the tax benefit theory which

39. Footnote 37 has been called the "most famous footnote in tax history." Bittker, *supra* note 3, at 277.

40. 331 U.S. at 14, n.37. "Boot" is a term used to describe "other property" received in an exchange which, but for such other property, would be nontaxable. *See, e.g.*, J. MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 20, 29 (1st ed. 1981) [hereinafter cited as MERTENS].

provides that if a deduction taken in a prior year is recovered in a later year, the amount recovered should be included in gross income in the later year.[41] Under the tax benefit theory the government can collect or "reclaim" the amount of a deduction taken if it later turns out that the deduction was unwarranted, or, instead of paying back an unwarranted deduction, some sort of later inclusion can be compelled to justify the deduction.[42] In *Crane* the taxpayer included the amount of a nonrecourse loan in her basis for depreciation purposes but failed to include the amount of the loan in the amount realized upon disposition of the property. The Court viewed this as taking a "double deduction," the first, when depreciation deductions were claimed, the second, when no accounting was made for those deductions upon disposition of the property.[43] To prevent such a double deduction from occurring the Court compelled the inclusion of the mortgage amount in the amount realized on the sale.[44]

The *Crane* Court concluded that the "property" inherited by the taxpayer was the apartment building itself and that the amount of the nonrecourse loan secured by the property was includable in the taxpayer's basis. The Court further held that, on these facts, the entire amount of the nonrecourse mortgage must be included in the amount realized upon disposition of the property.

41. *See generally* J. MERTENS, *supra* note 40 at § 7.34. The rule is of judicial origin and has been codified in various parts of the Internal Revenue Code. *See, e.g.*, I.R.C. § 111 (1976) which provides that when a prior deduction for bad debts, prior tax, or delinquency amounts resulted in an income tax benefit, then to the extent of the benefit, the recovery of these amounts in a later year must be included in gross income. I.R.C. §§ 1245 and 1250 (1976) provide for the recapture of depreciation deductions under similar circumstances.

"The tax benefit rule is both a rule of inclusion and exclusion: recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded*. The rule in both aspects evolved judicially and administratively." Putoma Corp. v. Commissioner, 66 T.C. 652, 664 n.10 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979) (emphasis in original).

42. *See, e.g.*, First Trust and Savings Bank of Taylorville v. United States, 614 F.2d 1142 (7th Cir. 1980) (bank realized income when personal property taxes paid and deducted from income for federal income tax purposes in 1972 were refunded in 1973); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967) (deductions taken by a taxpayer for a charitable contribution based on conveyance of realty were classified as income upon recoupment of the property where the taxpayer had obtained tax benefits from such deductions); Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940), *cert. denied*, 311 U.S. 658 (1940) (refunds of previously deducted taxes are to be treated as income in the year received). *See also, Requiem, supra* note 34, at 347 and authorities cited therein.

43. 331 U.S. at 15-16.

44. *Requiem, supra* note 34, at 347.

CRANE'S PROGENY

The *Crane* doctrine[45] became firmly established in the body of tax law and has continued to be the rule governing many transactions.[46] *Crane* was first extended to nonrecourse mortgage liens on property acquired by purchase where the full value of unassumed tax liens was held includable in the taxpayer's depreciable basis.[47] In another case, the absence of personal liability for a purchase-money mortgage did not preclude the inclusion of the amount of the mortgage in the depreciable basis of the property where the total circumstances of the transaction persuaded the court that the ultimate effect of the taxpayer's nonrecourse liability would be the same if he were personally liable on the debt.[48] Where a corporation acquired title in property, secured financing, executed leases and then transferred the property to individuals, subject to the mortgage and leases but without personal liability, the court found that the individuals acquired a depreciable interest in the properties.[49] The unpaid balance of the mortgage at the time of such transfer was, therefore, includable in basis for the purpose of depreciation.[50] Thus, the rule that bona fide nonrecourse debt is includable in basis is not in dispute.[51]

Similarly, *Crane*'s rule including nonrecourse debt in the amount

45. The *Crane* holding called for inclusion in basis and amount realized upon disposition of the property of the amount of any mortgage secured by the property, regardless of whether the mortgage is recourse or nonrecourse. 331 U.S. at 15-16.

46. For a discussion of cases decided after *Crane* and the status of the *Crane* rule today, see Weiss, *The Crane Case Updated*, 32 THE TAX LAW. 289 (1979) [hereinafter cited as Weiss].

47. Blackstone Theatre Co. v. Commissioner, 12 T.C. 801, 804-05 (1949). The court held that the full value of unassumed tax liens was includable in the purchaser's depreciable basis even though there was no personal liability as to the liens and the liens were settled after five years for less than half of their original value. The court in *Blackstone* said, "The factor of assumption or nonassumption of outstanding liens in a controversy such as here presented ceases to be controlling when the reality of the conditions and circumstances attendant upon petitioner's purchase of the property is appraised in light of the *Crane* case." *Id.* at 804. (footnote omitted). *See also* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 296 (1951) (the full amount of an unassumed mortgage was included in the taxpayer's unadjusted basis in an apartment building and in the amount realized upon foreclosure).

48. Mayerson v. Commissioner, 47 T.C. 340 (1966). In *Mayerson* the court stated:

> Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

Id. at 352.

49. Bolger v. Commissioner, 59 T.C. 760 (1973), acq. 1976-2 C.B. 1.

50. *Id.*

51. *See* Crane v. Commissioner, 331 U.S. 1 (1947). *See also* Mayerson v. Commissioner, 47 T.C. 340 (1966).

realized upon disposition of the property has been expanded.[52] Whether there is a limitation on the amount of nonrecourse debt that is includable in the amount realized is, however, a subject of continuing debate spurred by references to the hypothetical described in *Crane's* footnote 37.[53]

THE INTERNAL REVENUE SERVICE'S POSITION

In response to the effect of *Crane's* footnote 37 on tax consequences on certain transfers, the Internal Revenue Service (IRS) issued Revenue Ruling 76-111.[54] The IRS did not follow the Supreme Court's footnoted suggestion but instead it ruled that when a mortgagor transfers property subject to a nonrecourse mortgage to the mortgagee in satisfaction of the mortgage, the transaction constitutes a sale or exchange and the amount realized by the mortgagor will be an amount equal to the outstanding principal balance of the mortgage, even if this amount exceeds the fair market value of the property transferred. The ruling clarified the IRS stance on the proper computation of amounts realized upon disposition of property encumbered by nonrecourse mortgages. The rationale of the ruling was that when the transaction is viewed as a *whole*, the economic benefit to the transferor becomes readily apparent. The economic benefit is enjoyed by the taxpayer upon inclusion in his basis of the nonrecourse amount because the amount of basis is then utilized in calculating allowable depreciation deductions.[55]

Millar v. Commissioner

Millar v. Commissioner,[56] decided by the Court of Appeals for the Third Circuit in 1978, was, until *Tufts v. Commissioner*, the most significant decision following *Crane*.[57] In *Millar*, the taxpayer executed nonrecourse notes secured solely by certain shares of stock. When the stock was foreclosed because of nonpayment of the notes, the stock's value was less than the value of the notes. Relying on the tax benefit

52. *See* Weiss, *supra* note 48 at 302-08.

53. *See* Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719 (1975).

54. Rev. Rul. 76-111, 1976-1 C.B. 214. *See generally* Morris, *New Ruling Describes Deed Transfer in Lieu of Foreclosure as "Sale or Exchange"*, 45 J. TAX. 224 (1976).

55. *See* Rollyson, *Recent Cases and Rulings*, 3 J. OF REAL EST. TAX. 495 (1976).

56. 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979).

57. Prior to *Millar*, the issue of whether the full amount of a nonrecourse liability must be included in the amount realized when the value of the encumbered property was less than the amount of the liability was considered in Woodsam Assoc., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), and Mendham Corp. v. Commissioner, 9 T.C. 320 (1947). Both of these cases involved post-acquisition nonrecourse financing. *See also* Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

theory[58] and the rationale of *Crane*, the Tax Court included the entire value of the nonrecourse notes in the amount realized (received) by the taxpayer upon cancellation of the notes.[59]

The Third Circuit affirmed the holding of the Tax Court and refused to find that footnote 37 created an exception to the principal holding of *Crane*.[60] The court noted that the taxpayers had taken sizeable deductions calculated on a basis that included nonrecourse indebtedness. The court explained that to allow such deductions and then to limit the amount realized would be contrary to the "spirit and reasoning of *Crane*"[61] because it was just such a taking of "double deductions" that *Crane* prohibited.[62] *Millar*, following the reasoning and holding of *Crane*, embodied the accepted view of the treatment of nonrecourse liability upon disposition of the property; the full amount of such liability was to be included in the amount realized.

TUFTS V. COMMISSIONER

Facts of the Case

In August, 1970, taxpayers John and Mary Tufts became general partners of Westwood Townhouses.[63] The partnership financed the building of an apartment complex with a $1,851,500 nonrecourse loan.[64] Each partner included his allocable share of this liability in his basis.[65] Two years later, the principal amount of the loan remained unchanged but the fair market value of the property had declined to

58. *See supra* text accompanying notes 41-44, for a discussion of the tax benefit theory.

59. Millar v. Commissioner, 67 T.C. 656, 660 (1977), *aff'd in part*, 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1976).

60. 577 F.2d at 215. The court said:

> [T]his Court declines to accept a literal reading of that footnote [footnote 37] as the principal basis upon which this case should be decided. . . . First, it must be remembered that the footnote in *Crane* was *dictum*. Furthermore, the footnote was but a postulate or hypothetical observation with respect to a hypothetical set of facts not before the Court and, indeed, involving a clearly different time and clearly different legal circumstances.

Id. *See* McGuire, *On the Treatment of Realization of Gain on Recapturing Prior Deductions—Some Thoughts on Millar, Tufts, and Footnote 37*, 6 J. REAL EST. TAX. 132 (1979).

61. 577 F.2d at 215.

62. The *Millar* court quoted the following language of *Crane*: "The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets." 557 F.2d at 215, *quoting* Crane v. Commissioner, 331 U.S. at 15-16 (1947).

63. For a complete statement of facts see the Tax Court opinion, 70 T.C. 756 (1978).

64. *Id.* at 759.

65. *Id.* There is no dispute as to the propriety of such inclusion or any adjustments made. A partner's basis in his partnership interest includes his percentage share or partnership liabilities. I.R.C. §§ 722, 752(a) (1976). Treas. Reg. §§ 1.722-1, 1.752-1(a)(1) (1960).

$1,400,000.[66] At this time each partner sold his partnership interest and all of his right, title and interest in partnership properties to an unrelated third party who acquired the apartment complex subject to the $1,851,500 liability. The buyer paid the partners only the expenses incurred as a result of the sale.

Each partner reported the sale of his partnership interest on his federal income tax return and indicated that a loss had been suffered.[67] The taxpayers' position was that nonrecourse liabilities are includable in the amount realized upon sale or exchange of a partnership interest only to the extent of the fair market value of the property securing the indebtedness. Therefore, the amount realized on the sale of their partnership interests was less than their cash basis and the partners suffered a loss.

The Commissioner, however, included the full amount of the partnership nonrecourse liability in the amount realized on the sale. Since the taxpayers' allocable share of the nonrecourse liability was $462,875 and their adjusted basis was $355,653,[68] the Commissioner determined, in a notice of deficiency, that the taxpayers had realized a gain on the sale of their partnership interest in the amount of $107,222. The taxpayers appealed to the Tax Court for resolution of the question of whether the full amount of nonrecourse liability is includable in the amount realized upon sale of a partnership interest.

The Tax Court Opinion

The issue before the Tax Court was the extent to which partnership nonrecourse liability must be included in the amount realized upon the sale or exchange of a partnership interest. The taxpayers' position was that nonrecourse liability is includable only to the extent of the fair market value of the property.[69] The first of several arguments made in support of their contention was that footnote 37 of the *Crane*[70]

66. 70 T.C. at 761. The decline in value of the apartment complex was due to adverse economic conditions including substantial unemployment and overbuilding of apartments in the area of the complex. *Id.* at 760.

67. *Id.* at 761. Although their returns indicated a loss, no deduction was claimed for such loss. Taxpayers' petitions alleged that sales of their partnership interests in amounts equal to the full amount of basis resulted in deductible long-term capital losses. The petitions claimed refunds for overpayment of taxes, "in an amount to be determined by the Court." *Id.*

68. *Id.* at 762. In addition to his allocable share of the nonrecourse liability, Tufts' partnership basis included contributed capital in the amount of $2,771. His basis was adjusted by the following decreases: 1970 ordinary loss, $21,946; 1971 ordinary loss, $55,743; 1971 additional depreciation, $96; 1972 ordinary loss, $32,208. *Id.*

69. *Id.* at 763.

70. 331 U.S. 1 (1947).

opinion implied Supreme Court approval of the outcome urged by the taxpayers. The taxpayers contended that when the value of the property is less than the amount of the liability there is no real economic benefit to the taxpayer upon disposition, except to the extent of the fair market value of the property.[71] They concluded, therefore, that the economic benefit rationale underlying *Crane* and *Millar* does not apply. The taxpayers argued alternatively that the language of section 752[72] dealing with the valuation of partnership interests limits the amount realized on the sale of a partnership asset.[73] The taxpayers focused on subsection (c) and argued that the fair market value limitation of that subsection applies to the sale of a partnership interest under subsection (d). Thus, the amount realized on the sale of their partnership interest includes a partnership nonrecourse liability only to the extent of the fair market value of the partnership property subject to the liability.[74]

The Tax Court rejected the taxpayers' arguments. The court first analyzed section 752 and the legislative history of that section and concluded that the taxpayers' claim of a subsection (c) limitation on the amount realized was erroneous. Section 752 is generally regarded as a codification of the *Crane* doctrine for the purpose of determining the basis of a partner's interest in a partnership.[75] Subsection (c) limits the amount of liability that will be recognized *"for purposes of this section*."[76] Relying on the legislative history of section 752, the Tax Court agreed with the Commissioner's application of the language of subsection (c) only to subsections (a) and (b) which deal with increases and

71. 70 T.C. at 763-64.

72. I.R.C. § 752 (1976) provides:

(a) INCREASE IN PARTNER'S LIABILITIES—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) DECREASE IN PARTNER'S LIABILITIES—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) LIABILITY TO WHICH PROPERTY IS SUBJECT—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) SALE OR EXCHANGE OF AN INTEREST—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

73. The taxpayers argued that the limitation set forth in subsection (c) applies to the sale of a partnership interest under subsection (d). The Tax Court, however, agreed with the Commissioner's assertion that the two subsections operate independently. 70 T.C. at 766.

74. *Id.*

75. Perry, *supra* note 24 at 542.

76. I.R.C. § 752(c) (1976) (emphasis added).

decreases in a partner's liabilities. The court refused to apply the subsection (c) limitation to subsection (d), which deals with the sale or exchange of a partnership interest, concluding that the legislative history of section 752 suggests a narrow applicability of the subsection (c) limitation.[77] The court noted that the committee report stated, with respect to the sale or exchange of a partnership interest: "When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied."[78]

Further, the court noted that it is unlikely that there is a fair market value limitation on the amount realized, as the taxpayers suggested, because that would mean that Congress legislated the result that *Crane* prohibited. Since *Crane* ruled that the full amount of a nonrecourse mortgage must be included in the amount realized, the legislation codifying *Crane* must mandate a similar inclusion.[79] Citing its own decision in *Millar*,[80] the court explained that the rationale of the *Crane* holding, the prevention of double deductions, is still valid. The taxpayer in *Crane* took depreciation deductions computed on a basis which included the amount of a nonrecourse loan, then argued against the inclusion of such amount in the amount realized upon disposition of the property. The *Crane* Court had refused to allow this pattern of "double deductions." Faced with a similar fact situation in *Tufts*, the Tax Court also refused to allow the taxpayer to exclude the amount of the nonrecourse loan from the amount realized upon disposition of the property. Since the taxpayer had enjoyed the benefit of depreciation deductions calculated using a basis which included the nonrecourse loan, the court included the nonrecourse loan in the amount realized

77. The committee reports state with respect to § 752:

> Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as a result of a contribution of encumbered property by the partner to the partnership or as the result of a distribution of such property by the partnership to the partner. The provisions of this section prescribe the treatment for such transferred liabilities . . . .
>
> * * * * *
>
> The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.

H.R. REPT. No. 1337, 83d Cong., 2d Sess. A236 (1954); S. Rept. 1622, 83d Cong. 2d Sess. 405 (1954).

See also Treas. Reg. § 1.752-1(c) (1960).

78. H. REPT. No. 1337, 83d Cong., 2d Sess. A236-237 (1954); S. Rept. 1622, (Pub. L. 591), 83d Cong., 2d Sess. 405 (1954).

79. 70 T.C. at 767-69.

80. 67 T.C. 656 (1977), *aff'd in part*, 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979).

on the sale of the property.[81]

The court agreed with the Third Circuit's conclusion that footnote 37 was never intended to create an exception to the *Crane* holding. Since the Supreme Court did not have before it a situation where the fair market value was less than the mortgage amount, any comments on such a fact pattern were dicta. The court concluded, therefore, that the footnote stated only that if faced with a situation like the one in *Tufts*, the result might differ from the *Crane* holding.

The Fifth Circuit Opinion

The Court of Appeals for the Fifth Circuit reversed the Tax Court and, relying on footnote 37 of *Crane*,[82] ruled that the fair market value at the time of disposition of property securing nonrecourse debt limits the extent to which any relief of liability can be included in the amount realized.[83] The court focused on the two principal theories underlying *Crane*[84] and *Millar*[85]—the tax benefit theory[86] and the economic benefit theory.[87] With respect to the first theory, the court acknowledged that the taxpayer in *Crane* had benefited financially from the deductions taken but denied that the tax benefit theory was the controlling force behind the *Crane* decision.[88]

Addressing the economic benefit theory, the court agreed with the basic proposition that relief from a debt on which one is personally liable is a benefit to the taxpayer.[89] Upon a close examination of the underpinnings of the economic benefit theory, however, the court found the theory "seriously flawed."[90] The basis for the economic benefit theory is that "an owner of property, mortgaged at a figure less than that at which the property would sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations."[91] The court recognized that for owners whose property is subject to a nonrecourse mortgage the truth of this statement is limited to situations

81. 70 T.C. at 770. The Tax Court stated, however, that they did not pass upon whether nonrecourse liabilities in excess of the fair market value of the property securing such liabilities are included in the basis of a partnership interest acquired by purchase. *Id.* at 770 n.13.

82. *See supra* text accompanying note 40.

83. 651 F.2d 1058, 1063 (5th Cir. 1981).

84. 331 U.S. 1 (1947).

85. 557 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979).

86. *See supra* text accompanying notes 41-44.

87. *See supra* text accompanying notes 35-38.

88. 651 F.2d at 1060.

89. *Id.* at 1061.

90. *Id.* at 1062. *See* Bittker, *supra* note 3, at 281-82.

91. 331 U.S. at 14.

where the property owner wants to keep his property. Where he does not want to keep the property he can transfer it to another person without regard to payment of the mortgage or allow it to be foreclosed upon. The court noted, however, that although the owner of property subject to a nonrecourse mortgage has to pay the mortgage in order to keep the property, the owner incurs no economic benefit upon transfer of the property and the mortgage obligation to another because he has no personal liability. The nonrecourse mortgagor cannot benefit from relief of a debt for which he is not liable. Further, when the value of the property is less than the amount of the nonrecourse liability, there is little incentive for a debtor who is not personally liable to keep the property and continue payment on the debt. The personally liable mortgagor, on the other hand, has every reason to continue paying a mortgage regardless of the value of the property, merely because he is personally liable on the debt.

In view of this difference between recourse mortgagors and nonrecourse mortgagors, the *Tufts* court would not interpret "amount realized" on the disposition of property to include the assumption of a nonrecourse loan secured by that property. The Fifth Circuit held that the fair market value of property secured by a nonrecourse mortgage limits the extent to which relief of liability can be included in the amount realized upon disposition of the property.[92]

ANALYSIS

The Fifth Circuit's 1981 decision in *Tufts v. Commissioner*[93] was an unexpected reversal of the Tax Court. Until *Tufts* no court had found merit in the conclusion characterized by the Supreme Court as "obvious."[94]

Although it criticized both the tax benefit theory and the economic benefit theory, the *Tufts* court, to an extent, relied on these theories to arrive at its holding. The *Tufts* court stated that the Commissioner's reliance on the tax benefit theory was misplaced.[95] The court's inclusion in the amount realized of a portion of the taxpayer's nonrecourse liability is, however, evidence of its belief in the validity of the tax benefit theory. It was never argued that nonrecourse liability should be excluded from basis. Having accepted this inclusion, the court then

92. 651 F.2d at 1063.
93. 651 F.2d 1058 (5th Cir. 1981).
94. Crane v. Commissioner, 331 U.S. 1, 14 n.37 (1947).
95. 651 F.2d at 1061.

sought the counterbalancing effect that is at the heart of the tax benefit theory. Because the taxpayers in *Tufts* benefited from the inclusion in basis of the nonrecourse loan, inclusion of this amount in the amount realized upon disposition achieved the balance the court was looking for and preserved the symmetry of the *Crane* doctrine.

The *Tufts* court characterized the economic benefit theory, relied upon in *Crane*, as "seriously flawed."[96] The *Crane* Court justified its finding of economic benefit by comparing the recourse debtor and the nonrecourse debtor. Finding their actions similar—they must pay or lose the property—led the Court to conclude that their benefits upon relief of their liabilities are identical.[97] The *Tufts* court recognized that this analysis overstates the similarities between recourse and nonrecourse debtors.[98] The *Crane* Court was correct in stating that the owner of mortgaged property must maintain the payments in order to keep the property whether the mortgage is recourse or nonrecourse. If the owner no longer wishes to keep the property, however, the results of his failure to pay the mortgage are entirely different. The nonrecourse mortgagor can disregard the mortgage upon disposition of the property with no further economic consequences. The owner who is personally liable on the mortgage, however, is obligated to pay, even after he has disposed of the property. Thus, the similarities between the recourse and nonrecourse debtor noted by the *Crane* Court exist only when the nonrecourse debtor wants to keep his property which is mortgaged at an amount below the fair market value. The *Tufts* court was, therefore, correct that in a situation where the fair market value of property is less than the amount of the nonrecourse mortgage it secures, relief from the mortgage results in no economic benefit. To argue otherwise is to disregard economic reality.

The Third Circuit decided *Millar*[99] under the tax benefit theory. The taxpayer's sizeable deductions were followed by the court's inclusion of the nonrecourse loan in the amount realized. The court justified

96. *Id.* at 1062.

97. The Court stated:

> [W]e are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

331 U.S. at 14.

98. *See* Bittker, *supra* note 3, at 281-82.

99. 577 F.2d 212 (3d Cir. 1978), *cert. denied*, 439 U.S. 1046 (1979).

its inclusion as being within "the spirit and reasoning of *Crane*"[100] but dismissed footnote 37 as dictum.[101] The *Tufts* court did not follow the reasoning of *Millar* but, instead, founded its holding on footnote 37.

It could be argued that there is no solution to the "*Crane* dilemma"[102]—no reconciliation of the tax benefit and economic benefit theories when property is subject to a nonrecourse mortgage greater than the value of the property. If the amount of the mortgage is excluded from the "amount realized" upon disposition of the mortgaged property, taxpayers will have obtained the benefit of large depreciation deductions with little cash outlay and no recapture potential. The tax benefits of large depreciation deductions would seem to mandate some type of inclusion, but it is difficult to maintain that a taxpayer realizes an economic benefit in the full amount of a nonrecourse mortgage when that mortgage is assumed by another in that the taxpayer was never personally liable on such debt.

The solution lies in utilizing the tax benefit theory to justify inclusion while accepting a broader interpretation of the meaning of "economic benefit." Where a transaction is viewed as a whole, it is easy to recognize that the concept of "amount realized" need not be dependent on the receipt of a benefit in the accepted meaning of the word. Thus, the taxpayer's economic benefit is not "relief" from a mortgage for which he was never personally liable. Rather, his economic benefit is grounded in the total benefit enjoyed in the life of the investment, i.e., in the basis he has established and in the deductions he has taken. Upon subsequent disposition of the property, the benefit is accounted for by inclusion of the loan amount in the amount realized.

Another measure of the economic benefit received by the taxpayer becomes readily apparent when the transaction is viewed as a whole. Proceeds of a loan are not income. Receipt of the proceeds of a loan is not a taxable event because the expectation of repayment exists. It must be recognized, however, that a nonrecourse debtor has received the cash equivalent of the amount of the nonrecourse loan, regardless of the absence of the obligation to repay. The existence of the mortgage indicates the receipt of something of value.[103] The "something of

100. "A finding that the taxpayers did not realize gain as a result of this exchange after having realized the full economic benefit of this transaction, would entitle them to the type of double deductions of which the Supreme Court so clearly disapproved in *Crane*." 577 F.2d at 215.

101. *Id.*

102. Del Cotto, *supra* note 15 at 85. *See also Comment, Non-Recourse Liabilities: A Tax Shelter*, 29 BAYLOR L. REV. 57, 73-74 (1977).

103. Halpern, *Footnote 37 and The Crane Case: The Problem that Never Really Was*, 6 J. REAL EST. TAX 197, 219 (1979).

value" that was received was the use of a sum of money. When viewed in this context, it is not difficult to understand that the taxpayer has received an economic benefit in the full amount of the nonrecourse loan and such amount should be recognized as subject to taxation. The economic benefit occurred when the loan was received, only the timing of taxation is delayed until the property is disposed of or the loan is assumed by another.

The *Tufts* court suggests that the taxpayer be allowed to avoid taxation forever on a portion of the amount of nonrecourse loans if, at the time of disposition of the property securing the loan, the value of such property is less than the amount of the loan. This would result in a "no-lose" tax situation for taxpayers in such a situation. If, after taking substantial deductions, the taxpayer's investment was not providing an adequate return on capital, it could be disposed of, with no accounting made for either the initial loan, or deductions taken in excess of equity. The *Tufts* court, therefore, has bestowed a second advantage upon the nonrecourse debtor who has already realized a great benefit merely from the fact that his investment is nonrecourse.

It must be noted that Congress can, and often has, legislated answers to questions like the ones presented here. The Tax Reform Act of 1976, for example, limited the amount of deductions that can be taken by an investor to the amount he actually has at risk, the amount he has either contributed in cash or property, or for which he is personally liable. Investment in real estate was not included in this major reform.[104] It can be concluded that if Congress had intended to control situations like *Tufts*, they would have done so. Determination of amounts that are subject to taxation is essentially a policy consideration. Whether investment in real estate will continue to receive favorable treatment is a matter that should be addressed by Congress.[105]

The *Tufts* court must have anticipated the confusion which would accompany its decision because it provided a lengthy footnote to "put this case in its proper perspective."[106] In it, the court focused on its concern for the trend toward abuses of the tax law through various tax shelter schemes. The court summed up the problem as "the taxpayer's

104. I.R.C. § 465 (1976).

105. The problem may be resolved by legislation. A provision that would reverse *Tufts* is under consideration for submission to Congress. 54 STAND. FED. TAX REP. 3-4 (CCH) (1981).

Some commentators urge legislation to determine the correct resolution. *See, e.g.*, Del Cotto, *supra* note 15 at 103; Lurie, *Mortgagors With "Negative Equities" and "Negative Bases,"* 10 N.Y. U. INST. FED. TAX 86, 103 (1952).

106. 651 F.2d at 1063-1064 n.9.

ability to manipulate his basis and adjusted basis through the use of nonrecourse financing."[107] The court noted that the *Millar* decision had, no doubt, been prompted by the court's concern that inflated bases from nonrecourse financing will enable taxpayers to enjoy large tax deductions with no real economic loss. A second concern is that it seems unfair for a taxpayer to benefit from substantial deductions while placing little of his own capital at risk.

Although the *Tufts* court attempted to avoid the error it perceived in the rationales of *Crane* and *Millar*, it presented no clear solution to the taxpayer. Attaching the amount realized to the concept of "fair market value," as *Tufts* did, does not indicate to the taxpayer what the consequences of certain transactions will be and leaves him in doubt. As stated earlier, the tax benefit theory would have justified inclusion of the entire amount of the nonrecourse debt and would lend a certainty to the tax ramifications of transactions like *Tufts*. Given the fact that *Tufts* is not in accord with other recent Tax Court decisions[108] and is in direct conflict with the Third Circuit, it is not surprising that it is on the Supreme Court docket for resolution of this important question.[109]

107. *Id.*

108. *See, e.g.*, Freeland v. Commissioner, 74 T.C. 970 (1980) (relief from a nonrecourse debt was sufficient to support a finding of sale or exchange, even though the taxpayer had not benefited from depreciation deductions while he held the property).

109. As this article was going to press, the Supreme Court handed down its opinion in Commissioner v. Tufts, 103 S. Ct. 1826 (1983). Not unexpectedly, the Court reversed the court of appeals and held that when a taxpayer sells or otherwise disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property, the taxpayer may be required to include in the amount realized the outstanding amount of the obligation.

The Court's decision is consistent with *Crane v. Commissioner*, which it read as having approved of the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. Rejecting the assertion that *Crane* is founded on a theory of economic benefit, the Court noted specifically that the Commissioner had not characterized the *Tufts* transaction as cancellation of indebtedness. (103 S. Ct. 1826 n.11.) The Court also declined to employ a tax benefit analysis which focuses on the taking of deductions and the subsequent recovery of those deductions if proven to be unwarranted. (103 S. Ct. 1826 n. 8.) Thus, the Court's rationale embraces neither the economic benefit theory nor the tax benefit theory but, instead, rests upon the incurring of an obligation to repay loan proceeds received.

The Court recognized that when a taxpayer receives a loan he incurs an obligation to repay the loan. Because of this obligation the loan proceeds do not qualify as income to the taxpayer and the taxpayer is entitled to include the amount of the loan in computing his basis in the property. Because these calculations are made without regard to whether the loan is recourse or nonrecourse in nature the Commissioner is justified in including in the amount realized upon sale or other disposition of the property the amount of the unpaid obligation, whether it is recourse or nonrecourse. This symetrical treatment, requiring that a taxpayer account for the proceeds of obligations he has received tax-free and has included in basis, balances such inclusion and the original non-inclusion in income of the loan proceeds.

The Court rejected the contention that § 752(c) (26 U.S.C. § 752(c)) authorizes a limitation on the amount realized on the sale or disposition of partnership property. Relying on the legislative history of § 752, the Court concluded that the fair market value limitation of § 752(c) is directed to

CONCLUSION

Despite the apparent fairness of the Fifth Circuit's reversal of the Tax Court in *Tufts*, the court has not put forth a compelling argument in support of its solution to the "*Crane* dilemma." The Fifth Circuit's holding recognizes the essential difference between recourse and nonrecourse liability but ignores the crucial fact that even the nonrecourse mortgagor has realized an economic benefit. The *Tufts* decision can be characterized as a victory for taxpayers, but, because it is on such an uncertain foundation, it surely will not stand.

transactions between a partner and his partnership under § 752(a) and (b) and is not applicable to the sale or exchange of a partnership interest under § 752(d).

The decision of the Court is a reasonable interpretation of the statutory terms at issue and is consistent with *Crane*. Although *Tufts* further restricts the benefits which accrued to taxpayers as a result of *Crane*, the Court's decision rests upon a reasonable and logical foundation and is in accord with recent acts of Congress. (*See* 103 S. Ct. 1826 n. 7.)